Appian
Asset Management

Monthly Monitor

September 2020

Something Important Has Just Changed: The Long-Term Outlook for Financial Assets

There are a few events that when they occur cause fundamental change in Financial Markets. The Covid-19 pandemic is one such event and its significance is being overlooked by many market participants today. The pandemic and the response to it, look set to cause a fundamental change to the investment landscape as deflationary assets that have worked for the last few decades seem likely to struggle against significant headwinds whilst inflationary assets that have being lacking a catalyst to outperform now have one.

Asking the Right Question

Short termism is undoubtedly dominating financial markets today and this is evident by the fact that the average holding period for a stock today is less than five months. This explains the importance investors place on daily, weekly and monthly price movements, not to mind the year-end index price targets forecasted by strategists and analysts. All this short termism occurs despite there being a recognised wisdom that it is almost impossible to forecast the short-term trajectory of asset prices. The ultimate rewards within financial markets go to those who are prepared to look longer term and invest accordingly. The losers in Financial Markets are those who remain short-term focused and this is highlighted by the warning that greets investors when entering the website of a popular spread betting firm: “76% of retail investor accounts lose money when trading spread bets and CFDs with this provider”.

It is always important to ask the right questions and the right question today is not how many people will subscribe to Netflix this month but rather what are the longer term implications of the Covid-19 pandemic to the global financial system, as this is set to have the biggest impact on markets since the response to the Great Financial Crisis (GFC). Answering this question is critical to the path of many financial assets over the next decade. Our belief is that the responses to the pandemic are set to unleash significant changes on the investment landscape over the next economic cycle.

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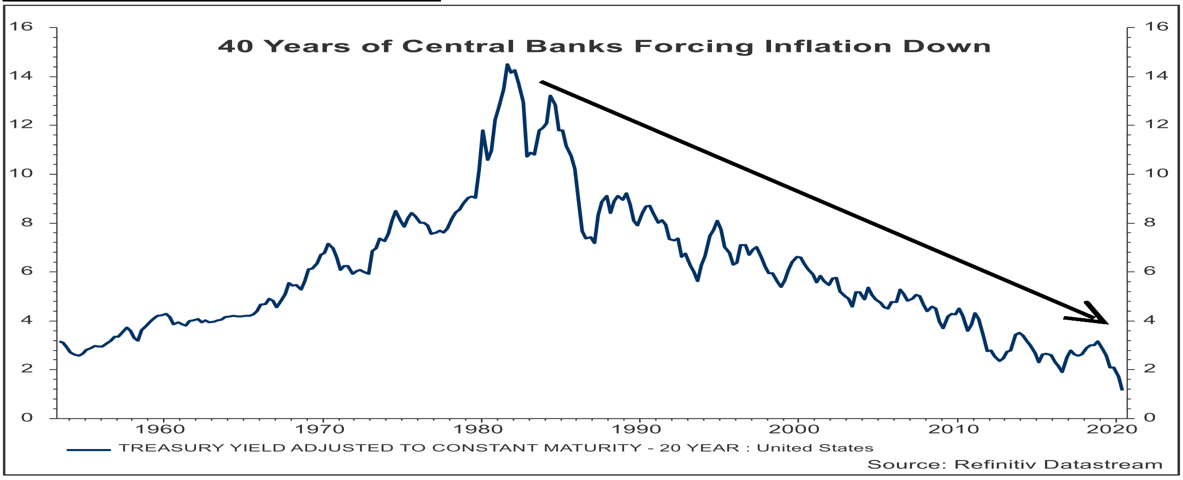
The Federal Reserve is Embracing Inflation

The most important conclusion from the current response to the pandemic, which is taking the form of looser fiscal and monetary policy, is that we believe it is going to result in a more inflationary backdrop than the world has experienced over the last two decades. The last economic cycle that emerged from the debris of the GFC was one, which was largely defined by lacklustre growth and low inflation.

This was the perfect environment for deflationary assets to prosper and prosper they did with government bonds hitting yields one never thought imaginable and growth stocks witnessing their valuations soar to levels not seen since the height of the dotcom bubble of twenty years ago. One of the strongest supports for our more reflationary call emerged recently as the Federal Reserve (Fed) stated that it is focusing on driving inflation higher, even if that level is above its mandated target. This is a hugely significant change as for the last 40 years Central Banks have tightened policy (sometimes prematurely) to guard against inflation. The move to a more inflationary environment has the potential to trigger many changes.

- **The End of the 40-year Bull Market in Bonds?**

Chart 1: US 20 Year Bond Yield



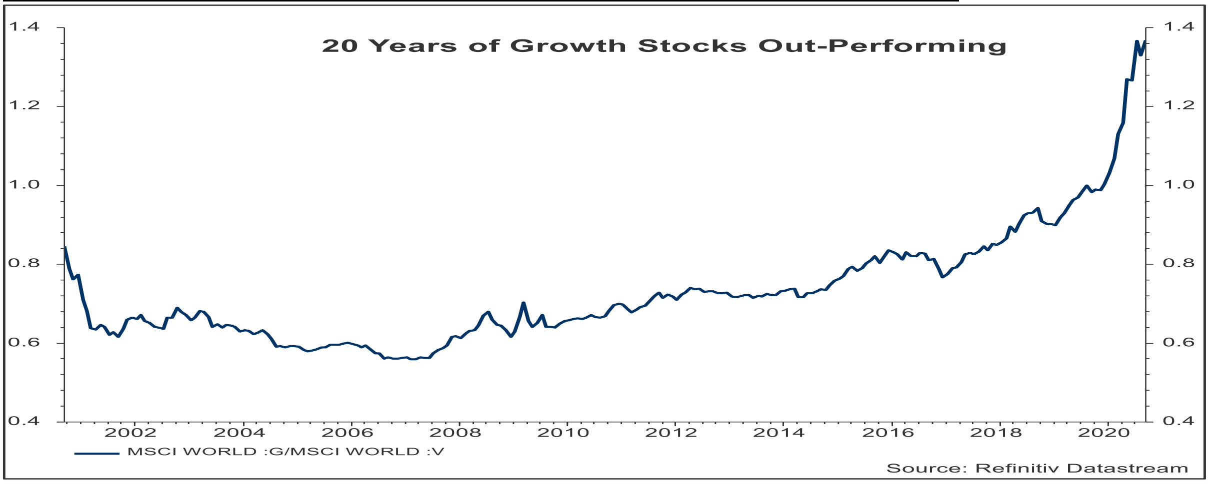
Source: Datastream Refinitiv, 14th September 2020

- The move by the Fed to focus on inflation will eventually be successful and result in long term bond yields rising, reversing the trend of the last 40 years where bond yields fell as Central Bankers concentrated on suppressing inflation. The Fed is now dedicated in getting Chart 1 moving in an upwards direction.

- The current moves by Central Bankers to stimulate their economies and increase inflation means that the traditional 60:40 balanced portfolio of equities and bonds is completely dead. Whilst the right equities still have a place in portfolios, the next decade is set to see money flow out of nominal bonds into other asset classes that offer inflation protection such as Commodities, Real Estate and Inflation Linked Bonds.

➢ The End of the Growth Bubble?

Chart 2: MSCI World Growth Index versus MSCI World Value Index



Source: Datastream Refinitiv, 14th September 2020

- Inflation coming back into the world brings risks and opportunities to the equity market. The first major risk is valuation risk - as bond yields rise, the value of equities comes down. Stocks whose valuation is more weighted to future profit streams are more susceptible to big negative moves from rising bond yields. These are the FAANG stocks of today.

The second major risk from inflation for equities is profitability as companies which do not have pricing power will struggle to pass on the effects of rising commodity and wage costs.

However, this new environment we are entering into is not all bad news for equities. There are equities that can benefit hugely in this type of reflationary environment as their earnings growth has the potential to eclipse any de-rating connected to rising bond yields. These include Resource Companies, Industrial Cyclicals, Financials and Food Retailers - the value part of the market today.

The End of US Dollar Supremacy?

The US dollar has become the Safe Haven asset of choice over the last 20 years. However, the current approach by the Fed to push for higher inflation casts a doubt over whether it will be the place for the next decade. We are already beginning to see the US dollar weaken. It's not risk-free anymore.

The Return of Small Cap Out-Performance?

A side effect of the trends of recent years of money flowing into bonds and US Mega Cap stocks is that Small Cap equities, particularly outside the US have become almost ignored by investors. Given the valuation of this group of equities and the fact it tends to benefit from an inflationary environment means that we could be on the brink of the start of another period of Small Cap out-performance.

Rotation from Passive Financial Products into Actively Managed Products?

Will investors globally recognise the changes that are afoot and change from passive balanced funds that offer little inflation protection and index funds that are top heavy in US Mega Cap growth stocks? The answer is probably not despite the Fed trying their best to tell investors that the world has changed. Most remain too obsessed with short-term price moves and are unable to see the wood from the trees.

Appian AM NAV's Fund Prices 31-08-2020

NAV		MTD	QTD	YTD	SI
		%	%	%	%
AMAF	147.5442	1.38%	2.03%	-7.29%	47.54%
AGDGF	172.7102	4.02%	3.69%	-19.44%	72.71%
AGSCOF	153.6298	5.24%	8.49%	-17.96%	53.63%
AIF	107.2796	3.45%	4.69%	-3.14%	7.28%
AELF	103.2337	-	-	-0.46%	3.23%

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Warnings

- **If you invest in any of the funds you may lose some or all of the money you invest.**
- **Past performance is not a reliable guide to future performance.**
- **Appian Funds may be affected by changes in currency exchange rates**
- **The value of your investment may go down as well as up.**

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